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THE DIRECTOR OF
CENTRAL INTELLIGENCE

Executive Registry

National Intelligence Council

25- 426313

31 October 1985

NOTE FOR: DDCI

FROM:

Acting NIO for Economics

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SUBJECT: Talking Points and Attachments

Attached are the talking points and some additional background material for the Friday NSC meeting on S. 812. I was told that Weinberger will speak on the deflection of Western credits to the Third World and Soviet uses of Western technology, citing the TTAC white paper which I have enclosed for you. Hence, your talking points will not be redundant with his presentation.

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Attachments:
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DCI TALKING POINTS: NSC Meeting on Senate Bill 812

LIST OF ATTACHMENTS

Attachment A: Acquiring Western Technology

Attachment B: Advanced Industrial Technologies in the USSR:
Progress and Problems

Attachment C: USSR: The Role of Foreign Trade in the Economy

Attachment D: USSR: Implications of Reduced Oil Exports

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ATTACHMENT C

USSR: The Role of Foreign Trade in the Economy

Foreign trade plays an important, albeit not critical, role in Soviet economic development. Although the Soviet economy is largely self-sufficient--purchases from abroad account for only about 10 percent of GNP--imports have helped Moscow improve consumption, boost productivity, remove industrial bottleneck, and modernize weapon systems. [REDACTED]

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East-Versus West as a Source of Imports

The USSR has traditionally favored its communist allies in its foreign trade.

- o About 65 percent of the USSR's machinery and equipment imports come from its Communist allies, mostly the East European countries.
- o These imports represent nearly half of all Soviet purchases from Communist countries. (See Figure 1)

Although East European machinery and equipment is often of lower quality than Western equipment, it is equal to or better than Soviet produced goods in many instances. The USSR also looks to Communist countries for manufactured consumer goods to supplement its own production. More than half of such imports--primarily clothing and furniture--are purchased in Eastern Europe. [REDACTED]

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While relying on Eastern Europe for much of its machinery and equipment needs, imports of Western technology and equipment have been essential to expand selected Soviet industries (e.g. chemicals and automobiles), despite difficulties in assimilation.

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- o Imported chemical equipment in the 1970s was largely responsible for the output of ammonia, nitrogen fertilizer, and plastics doubling during this period.
- o Construction of the Kama river truck plant, which is based almost exclusively on Western equipment and technology, has resulted in a roughly 100 percent increase in Soviet heavy truck output over the past decade.

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Imports from the West also have played a key role in supporting the energy sector.

- o The rapid construction of the Siberia-to-Western Europe gas pipeline would not have been possible without purchases of Western turbines, compressors, and pipe.
- o Difficiencies in Soviet drilling, pumping, and exploration have promoted Moscow to purchase almost \$20 billion in oil and gas equipment since 1975.

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Imports of grain and other agricultural products have been the largest component of the USSR's western trade, however. A series of mediocre harvest during 1981-84 has pushed agricultural imports to record levels--with average annual purchases of some \$10 billion during this period. Because of the limited ability of Communist countries to expand grain production, Moscow has had to rely almost entirely on Western countries to fill the gap between domestic output and requirements.

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Finally, in addition to contributing to specific industrial sectors and overall consumer well-being, acquisition of goods and technology from the West has enhanced Soviet military programs.

- o Access to specific technologies has permitted improvements in a number of weapon and military support systems.
- o Gains from trade, in general, have improved the efficiency of the economy and thereby reduced the burden of defense.

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Foreign Trade Under Gorbachev

Since taking over as General Secretary in March, Gorbachev has made it clear that improved economic performance is his top priority. His plan focuses on modernizing the industrial base with more and better machinery--a strategy which could lead to an increased role in both Eastern Europe and the West.

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Gorbachev is undoubtedly hoping for an increase in the flow of machinery from Eastern Europe. Since taking over, he has spoken about the need for broader and tighter intergration within CEMA. While such rhetoric is not new--the USSR has long advocated joint production and specialization within CEMA as a means of getting the East Europeans to cough-up more--Moscow

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seems more intent than ever on pressing its allies to make firm commitments on this issue. In this regard,

- o An agreement signed by CEMA Prime Ministers in June pledged multilateral cooperation in designing and producing computer controlled systems.
- o The agreement follows a recent call in PRAVDA for a 50-100 percent increase in the rate of growth in machine-building in CEMA countries during 1986-90.

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Moscow is probably limited in just how much it can get from its allies. Because most East European countries are constrained by their own resource and economic difficulties, any sharp increase in machinery exports to the USSR would have to come at the expense of much needed domestic investment or sales to the West that bring in hard currency. Such a shift would risk undermining growth prospects throughout the area which could cause serious political problems.

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The limited prospects for sharply boosting imports from Eastern Europe increases Moscow's incentive to trade with the West. In particular, Gorbachev probably will look to the West for imports of technology and equipment for selected sectors--energy and electronics, for example--where no good supply alternatives exist. Moreover, Moscow is presently in a good financial position to increase its purchases of Western machinery and equipment--at least in the near-term.

- o With a relatively small debt and approximately \$10 billion in assets in Western banks at yearend 1984,

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Moscow can easily obtain commercial credits to finance new purchases.

- o Most West European countries are also offering generous terms on government-backed credits in an effort to balance trade with the Soviets and spur their own economies. []

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Over the longer term, however, Moscow's financial position is much less certain--falling world prices for oil and declining domestic production could limit Soviet hard currency earning capacity. []

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Looking to the US Prospects for an expansion of Soviet purchases of US machinery and equipment appear good--albeit from the extremely low levels of recent years. The share of machinery and equipment orders going to the US during first quarter 1985--10 percent--is substantially above last years 6 percent figure and, if maintained, would be the highest since 1979. (See figure 4) Moreover, the US-Soviet Joint Commercial Commission talks in May 1985 produced a Soviet pledge to

- o Try to do more business with US firms.
- o Put interested US firms on bidders lists.
- o Fully consider US proposals on their economic merit. []

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In this regard, we have seen an improved tenor in US-Soviet contract negotiations since the beginning of the year. The Soviets are currently discussing major deals with US firms for the sale of personal computers, energy equipment, and agricultural technology. Although these negotiations may be

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protracted, some signings appear likely. [REDACTED]

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Nevertheless, the vast majority of Soviet purchases from the US will continue to be agricultural products. Under the current long-term US-Soviet grain agreement (which expires in 1988), Moscow is committed to purchase a minimum of 8-9 million tons of grain per year, with a value of roughly \$1 billion at current world prices. In poor crop years, Soviet purchases can be expected to be much larger. [REDACTED]

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Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

4 September 1985

USSR: Implications of Reduced Oil Exports

Summary

Steadily declining oil production in the USSR apparently is preventing the Soviets from sustaining oil exports to the West. Soviet hard currency earnings from oil sales could decline substantially in 1985--possibly by as much as \$3-4 billion, or over 10 percent of total hard currency export earnings. There are few signs that deliveries to Eastern Europe will be cut this year. If the Soviets continue to insulate Eastern Europe from oil disruptions, such a policy would be in stark contrast with the way the USSR handled a tight hard currency situation in 1981-82, when it eventually diverted oil deliveries from Eastern Europe to the West. [redacted]

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Until very recently, Moscow has shown little sign of serious concern about its hard currency situation and we believe that the USSR is in a good position financially to handle the sharp decline in oil export earnings for the balance of 1985. If oil-export earnings remain depressed, however, Moscow probably will soon be forced to take more active measures, including possibly substantially increased borrowing, import cutbacks, and selling more gold. [redacted]

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For the longer term, a continued decline in oil output--and reduced prospects for oil exports--will pose some difficult choices for the leadership. Indeed, Gorbachev is currently visiting the West Siberian oil and gas region probably to get a hands-on feel for the problem before finalizing investment choices for the coming five-year plan.

- o There is little room for increased diversions of oil from the domestic economy in order to boost exports to the West,

This memorandum was prepared by [redacted] in the National Issues Group of the Office of Soviet Analysis. Comments and queries may be addressed to Chief, National Issues Group, SOVA on [redacted]

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a maneuver the Soviets have used in recent years to sustain hard currency exports. Some slight savings from conservation and substitution programs will probably be realized, but the prospect for widespread savings is not bright. Thus, any major cutbacks in domestic oil allocation are likely to result in disruptive bottlenecks that would threaten Gorbachev's modernization program and perhaps cost him some political setback.

o Substantial cutbacks to Eastern Europe would result in serious economic difficulty to the economies of the region. Moscow will have to weigh carefully the attendant risk of economic instability and increased political tensions in the region that could stem from such cutbacks.

o The Soviets will need to continue importing sufficient quantities of grain and feedstuffs for the livestock program, and obtain the necessary industrial materials to prevent production bottlenecks. Increased imports of Western machinery also would seem necessary if Gorbachev's industrial renovation targets are to be met. [REDACTED]

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Facing these conditions, Moscow probably has no alternative but to accept some continuing decline in its oil exports to the West, while trying to reap whatever savings it can from the domestic economy and Eastern Europe. In our judgment, the Soviets will continue to import essential agricultural and industrial goods, and will have sufficient earnings to purchase Western machinery and technology that have the highest priority. But reduced hard currency availability could affect other planned imports of Western equipment at a time when the Soviet demand for such goods is likely to increase as a result of Gorbachev's modernization program. [REDACTED]

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Production Problems Grow

Soviet domestic oil output fell last year--by about 100,000 barrels per day (b/d)--the first time since World War II. On the basis of the oil industry's recent performance, including 14 months of declining output, we judge that production for 1985 will fall by over 300,000 b/d, or by about three percent. [REDACTED]

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Moscow is becoming increasingly concerned about its oil

prospects. Major steps taken by the leadership to prevent declines in oil output have been to no avail. Last year, Moscow increased substantially investment in oil production, and earlier this year it overhauled the management of the oil sector. In early August, the Politburo decided on a 60 percent increase in construction and assembly work for the West Siberian oil and gas complex in the 1986-90 period. Such measures offer some prospect of slowing the longer-term decline in output, but can do little to improve oil output in the next year or two. The high level of concern was most recently reflected in Gorbachev's trip to West Siberia on 4 September, probably intended to give him a hands-on feeling for the problem before finalizing investment choices for the coming five-year plan. [REDACTED]

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Reduction in Oil Exports

The West. Soviet oil exports to the West declined by about 40 percent during the first quarter this year compared with the same period in 1984. This was largely due to the harsh winter, which hampered oil production and sharply increased domestic oil consumption. Although few data are available, oil exports apparently rebounded during the second quarter--but not enough to offset the earlier declines, according to reporting from Western oil traders. [REDACTED]

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Traditionally, the Soviets have substantially accelerated oil exports in the latter months of the year to offset low first-

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quarter deliveries. According to Western journals with excellent contacts in the energy markets, however, oil traders expect the USSR to cut contract deliveries of oil by between one-third and one-half for an indefinite period beginning as early as September.¹ The Soviets have not made an official announcement, but, according to the reporting, have given some customers verbal notice several weeks in advance. Although similar press "warnings" have not been completely borne out in the past, the recent events are unusual.

- o The Soviets generally provide only short notice on reductions or cancellations in contract deliveries. This time, they reportedly informed some customers several weeks ago, which suggests that the export difficulties may be major.
- o When the USSR has claimed "force majeure"² in the past, the declarations were usually accompanied by statements that the disruptions in deliveries will be temporary or made up later. Such qualifications are notably absent this time around.

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Some cutbacks are already taking place. Some customers of Soviet oil reported in the Western press that gas-oil deliveries to Western Europe were reduced in August. In addition, in the spot market--where the USSR makes roughly half of its sales to

¹ These cuts suggest that Moscow seriously underestimated the difficulty of turning around the slide in oil production that was evident in late 1984. The Soviet State Planning Committee (GOSPLAN) annually allocates approximate quantities for export to the West. These allocations, in turn, provide the basis for the spate of oil-export contract signings at the beginning of each year.

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² Force majeure is a contract clause that exempts a party from fulfilling a contract due to extraordinary circumstances.

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the West--prices for Soviet oil in recent weeks have risen faster than the market as a whole, which probably reflects scarcities of Soviet oil available there. Such movements in prices in the past have preceded a substantial decline in Soviet oil sales. []

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To our knowledge, the Soviets have not tried to boost oil imports from the Middle East for reexport to the West. During the first few months of the year, the reexports averaged about 300,000 b/d, about the same level as during all of last year. The Soviets in recent years have been able to increase oil deliveries from OPEC--particularly from Libya and Iraq in payment for arms purchases--as a way of increasing its overall exports to the West. []

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Eastern Europe. Less information is available on Soviet oil exports to Eastern Europe, but there are only indications of some sporadic and small-scale cutbacks to Yugoslavia and Bulgaria. A Bulgarian energy official recently told a reliable source that lower Soviet deliveries of oil and coal this year have forced Sofia to increase its purchases of energy on the international markets. The official asserted that Moscow told Sofia that the USSR has its "own problems to contend with." []

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Nevertheless, in our judgment, Moscow is doing its best to sustain oil deliveries to the region. The Soviets almost certainly would not make any substantial cutbacks in midyear, as this would be extremely disruptive on any centrally planned economy. Rather, any reduction in such deliveries--as was the

case in 1982--would be made at the beginning of the following year, in concert with overall economic planning on an annual basis. The absence of grumbling from the East Europeans suggest that reductions in deliveries to the region are only marginal, and that no Soviet announcement has been made of a larger, more general cutback for next year. [REDACTED]

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Implications for Hard Currency Earnings

Near Term. The expected decline in the volume of oil sold to the West, combined with lower world oil prices (which so far have averaged almost 10 percent below prices during January-August last year), could lead to a reduction in hard currency earnings of about \$3-4 billion for 1985 as a whole. This would be a drop of 20 to 25 percent in earnings from oil sales, and a decline of more than 10 percent in the USSR's total hard currency earnings. [REDACTED]

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Moscow cannot compensate for this drop by expanding other exports. Soviet earnings from natural gas sales to Western Europe are not expected to rise substantially this year. On average, Soviet gas prices have fallen somewhat, and the USSR has allowed at least one nation to postpone increases in purchases of Soviet gas. Other exports--including sales of metals, machinery, and weapons--face limited Western or LDC demand and, in some cases, constrained domestic availability. [REDACTED]

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The USSR is probably in a fairly good financial position to

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cope with this year's oil export decline. At the end of March Soviet assets in Western banks stood at a comfortable \$8.8 billion. So far, Moscow has shown few signs of serious concern about the need to compensate for a major drop in oil earnings.

- o Gold sales appear to be up only slightly over the relatively low levels in 1984.
- o While Moscow has borrowed close to \$1 billion from the West so far this year, most of this money apparently has been used to pay off earlier, higher-priced loans.
- o The Soviets turned down a French offer of approximately \$500 million in credits for Astrakhan' and Tengiz energy development contracts, which were signed this spring. (NF)

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The expected erosion of its oil export earnings during the balance of 1985, however, could force Moscow to take more active measures in the near future. Options exercised in the past to deal with hard currency shortages include increases in net borrowing, cutbacks in imports, and larger gold sales. In response to a hard currency bind which developed in the first half of 1981, Moscow cut back hard currency allocations to the foreign-trade organizations in late 1981 and early 1982, causing delays in purchases and payments. In addition, the Soviets substantially increased short-term borrowing (mainly for grain purchases) and gold sales.

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On balance, we believe that the USSR is financially in a good position to satisfy most, if not all, of its import requirements from the West in 1985. Moscow will be helped this year by a better domestic grain crop and thus substantially

reduced grain import requirements in the latter half of the year.³ In addition, overall imports of Western industrial goods during the first quarter were lower than during the comparable period in 1984. It is not yet clear whether such imports have remained at reduced levels since then. While Soviet orders for machinery and equipment are up sharply during the first half of the year compared with last year, actual imports of machinery and equipment will not begin to rise until 1986 or beyond, given the usual lags in implementing contracts for large projects. Moreover, many of the deals are financed by long-term credits.

[REDACTED]

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Nevertheless, there is some evidence that the Soviets are becoming increasingly concerned about their financial situation.

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[REDACTED] officials were very concerned about their need for hard currency. They indicated that the USSR was facing an unprecedented and tremendous financial crunch, and that an effort had to be made to close the gaps between earnings and projected expenditures.

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[REDACTED] and it is not clear whether the "gaps" applied to the current situation or to projections of a longer-term decline in hard currency exports.

[REDACTED]

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³ Moscow also should enjoy the benefits of a buyer's market this year in the international grain trade. World supplies are expected to be abundant, largely because of a bumper crop in the United States.

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Longer Term. Beginning in the next year or so, the Soviets will likely have to deal with steadily declining export earnings from oil.

- o Domestic oil output continues to slide despite substantial increases in investment in the oil industry. Although the oil industry management has been overhauled, prospects for a turnaround in output are poor.
- o World oil prices continue to slide with little prospect for a reversal until the late 1980s.
- o Opportunities for boosting arms sales to OPEC nations--the traditional source for increased oil imports--are limited by the ability of these nations to absorb and pay for more arms.

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Moscow has been hard pressed to compensate for the production decline by reduced domestic consumption. It has been trying to reduce the economy's use of oil for several years, primarily through energy conservation and programs for switching to the use of gas instead of oil in industry. There have been few signs so far that the USSR has, in fact, reduced its oil use. The Soviet press has been mum on successes in this area, suggesting that progress is dragging despite the leadership's emphasis on conservation. In addition, our analysis of the electric power industry--the main target of the gas-for-oil substitution programs--indicates that the oil "saved" at some power plants has been consumed anyway in offsetting major shortfalls in the supply of coal to other power plants and in producing above-plan amounts of electricity.

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Prospects for limiting demand during the next several years also are not bright. Gorbachev's program for retooling and installing more energy efficient equipment promises substantial savings, but only in the long run and after considerable expense. Over the next several years, the modernization program, vigorously pursued, will itself consume large quantities of fuel. Indeed, given Gorbachev's stated objectives, the mix of output is likely to become more rather than less energy intensive. [REDACTED]

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Implications for Eastern Europe

Moscow's allies would have considerable difficulty coping with a cutback in Soviet oil deliveries. Most of the countries in the region--plagued by sluggish export growth, large debt-service obligations, and uncertain borrowing prospects--do not have enough hard currency to purchase a substantial portion of their oil requirements on the international markets. Moreover, securing more oil through barter arrangements has been made more difficult because of a reluctance on the part of Third World countries to increase such deals. [REDACTED]

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Moscow repeatedly has told its allies that deliveries will not be cut in 1986-90. It made a similar promise in 1980, however, for the 1981-85 period, but cut deliveries anyway in 1982 when it needed to increase hard currency earnings. In aggregate, oil shipments to the region have not increased since

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then. []

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The East Europeans survived the 1982 cutbacks without much difficulty because the region was reexporting some Soviet oil for hard currency. Cuts during 1986-90 would be much more troublesome as they likely would come out allocations for the domestic economies--at a time when Moscow will be putting more pressure on East Europe to increase production and delivery of energy-intensive goods (i.e. machinery and equipment). Balance-of-payments constraints would limit East European purchases of oil from hard currency sources, and reduced oil consumption in the region would affect economic productivity and growth. Lower growth would increase the likelihood of political instability in Eastern Europe and increased public resentment toward the Soviet Union. []

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Implications for Trade With the West

Moscow probably has little alternative but to accept some continuing decline in its oil exports to the West, while trying to reap whatever savings it can from the domestic economy and Eastern Europe. Faced with prospects for substantially reduced hard currency earnings, the Soviet leadership may be hard pressed to satisfy the entire range of import goals in the coming years. We believe, however, that the Soviets will continue to import sufficient quantities of grain and feedstuffs to keep the livestock program on track and obtain the industrial materials

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needed to reduce production bottlenecks. []

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The reduced availability of hard currency will probably affect imports of Western machinery and equipment the most. Barring a series of harvest failures and/or an unexpectedly rapid decline in oil production, Moscow should be able to earn enough hard currency through 1990 to purchase Western equipment that has the highest priority--equipment needed to develop oil and gas reserves at Astrakhan' and Tengiz, for example. But any cutback in imports of other Western machinery and technology would be occurring at a time when Soviet demand for such goods is increasing as a result of Gorbachev's modernization program. A less conservative borrowing policy could allow Moscow greater leeway in setting the level of these imports. []

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Changes in Soviet purchasing strategy may provide early indication of how the Soviets are assessing their prospects for oil production and hard currency exports. Specific indicators might include:

- o Scaling back, stalling, and/or cancelling project negotiations now underway.
- o Insistence that countertrade arrangements be included for all but the highest priority purchases.
- o Greater concentration on domestic projects oriented toward supplying the export market when negotiating purchases from the West. []

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